

January 7, 2003

To Members of the General Assembly:

This Annual Report is presented to assist you with a general overview of the State's financial condition in the particular areas of debt, investments and cash management, as well as other matters within the purview of the State Treasurer's Office. A general understanding of these issues will also assist the committees to examine the appropriations to the Treasurer's Office operating budget as well as the appropriations for debt management.

The Appropriations and Institutions Committees, in cooperation with the Administration and this office, have been active partners in returning Vermont to fiscal stability and to a course of reducing the high debt burdens that the State had accumulated.

In recent years we began to trend down new authorizations of long-term debt to overcome Wall Street rating agency concerns. Consequently, the State has reduced its new authorizations from \$83.4 million in FY'91 to \$39 million in FY'03. As a result of this policy, the State's total debt decreased over the last five years from \$528.6 million as of June 30, 1998, to \$460.5 million as of June 30, 2002, a decline of 12.9%. Also more expensive financing mechanisms employed in the past, such as long-term capital lease obligations and certificates of participation, were refinanced with lower cost general obligation bonds.

Between September 1999 and September 2000, the State's bond rating was upgraded by all three rating agencies. Standard & Poor's upgraded Vermont's rating from AA to AA+. Moody's Investors Service upgraded the State's rating from Aa2 to Aa1 and Fitch upgraded the State from AA to AA+. All three rating agencies recognized many improvements in Vermont's fiscal policies, financial management operations, debt burden, and uncomplicated debt management systems. Vermont's ratings were continued by the agencies in December 2002 and remain the highest in New England.

In November and December of 2001, the State issued \$51 million in General Obligation Bonds. This represented the authorized debt of \$12 million for FY'01 and \$39 million authorized for FY'02. In December 2002, the State issued \$30.8 million in General Obligation Bonds and will issue \$5 million in Citizens Bonds in January 2003 for a total of \$35.8 million.

The State took advantage of low interest rates and also issued Refunding Bonds in the amount of \$31,555,000 in December 2002. These Bonds refinanced a portion of the State's 1993 Series B General Obligation Bonds. This financing resulted in a present value savings of 2.95%, or \$942,909.

As we prepare for fiscal year 2004, the Capital Debt Affordability Advisory Committee recommends that the State authorize new long-term debt in an amount not to exceed \$39 million. This level of debt issuance has had a positive impact on the key debt indicators monitored by the Committee and resulted in a significant reduction in the State's level of outstanding debt. The Committee agreed to consider modest increases beginning in FY '05 by building an inflation factor into the \$39 million authorization for future years. Because of the decline in the economy and decrease in the State's revenue and resulting pressures on the FY'04 budget, the Committee declined to increase its recommended authorization for FY'04.

The State Treasurer is responsible for investment of the State's cash. The State's short-term portfolio earned nearly \$4.8 million in interest income in fiscal year 2002, a yield of 2.3%, on an average daily balance of \$189 million. This yield exceeded the average return on the three-month treasury bill auction rate of 2.1%. The yield on the State's short-term investments is attributable, in part, to the short-term investment program instituted by this office. Daily offerings are solicited from the institutional trading desks of dozens of national and local brokers in order to achieve the maximum rate of return and diversification in the portfolio.

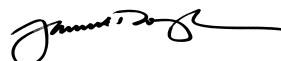
For the first time since FY'99, the State's cash position in FY'03 necessitated the borrowing of \$75 million in August 2002 as cash flows projected a deficit of that amount in December 2002. The State issued \$75 million in revenue anticipation notes that mature on June 16, 2003. The notes bear a coupon rate of 2.5% and gross interest on the notes is \$1.5 million.

The Abandoned Property Division of the State Treasurer's Office holds more than \$17.4 million in unclaimed property, up from \$16 million last year. Over \$3.5 million in unclaimed property was turned over to the State in fiscal year 2002 and nearly \$1.8 million in claims were paid.

We continue to operate in a period of economic and financial uncertainty. The recession has caused the loss of thousands of jobs in Vermont, along with shrinking revenues and investment returns. This will not be an easy session, but it's essential that we maintain the progress we've achieved in recent years of moderating our debt and enhancing our credit ratings.

I look forward to working with the General Assembly to attain our shared goal of continued fiscal stability for the State of Vermont.

Sincerely,



James H. Douglas
State Treasurer

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Pension Financial Statements

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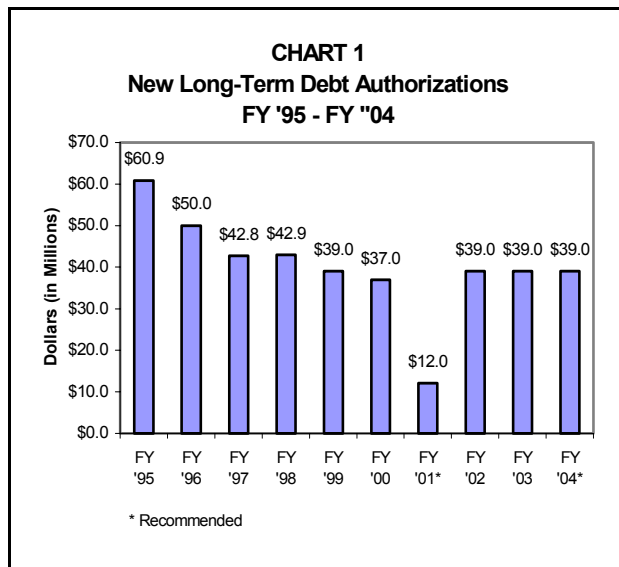
Annual Report to Vermont Higher Education Commission

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I. DEBT MANAGEMENT

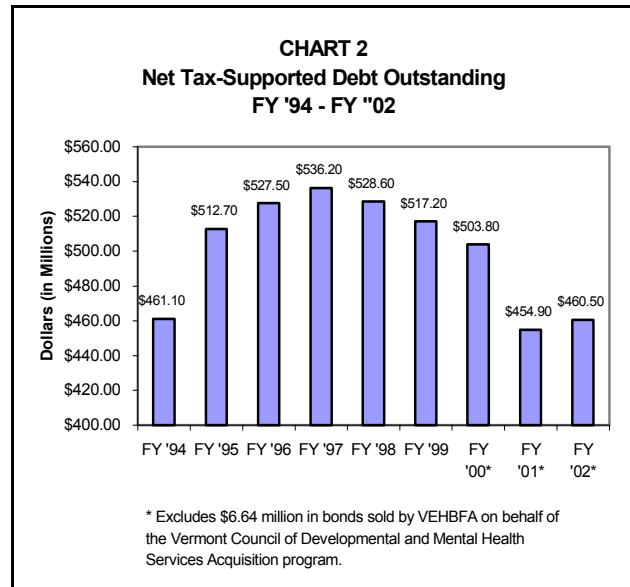
A. GENERAL OBLIGATION DEBT

Since fiscal year 1995, the State Treasurer's Office, in conjunction with the Administration, has set a course to trend down new authorizations of long-term debt to overcome concerns of the major Wall Street rating agencies. Consequently, the State has reduced its new authorizations for general obligation debt from \$60.9 million in FY'95 to \$12 million in FY'01 and \$39 million in FY'02 and FY'03. (See Chart 1.)



By lowering new authorizations, the State of Vermont has begun to reduce its total level of outstanding long-term debt. The State's total debt decreased from \$503.8 million as of June 30, 2000 to \$454.9 million as of June 30, 2001, a decline of 9.7%. (See Chart 2.)¹ The total debt outstanding increased to \$460.5 million as of June 30, 2002. The increase in FY '02 is due to the fact that no bonds were issued in FY'01 and \$51 million in bonds were

issued in FY'02. For the same reason, the State issued \$5.6 million more general obligation debt than it retired in FY'02. The State issued less general obligation debt than it retired in each of fiscal years 1999-2001.



In 1999, the Capital Debt Affordability Advisory Committee recommended a policy of maintaining a yearly issuance of \$39 million of new debt into the foreseeable future because that level will have positive effects on key debt ratios monitored by the Committee. For FY'01, the Committee recommended an issuance of \$34 million that was \$5 million less than the targeted annual issuance in order to compensate for a lease-purchase authorization by the 1999 Legislature for the Agency of Transportation. The \$5 million lease-purchase authorization was repealed by the Legislature during the 2000 session and cash was appropriated. The Legislature allocated an additional \$22 million in surplus cash to the reduction of authorized debt leaving a total of \$12 million authorized for FY'01.

¹ The State Treasurer's Annual Report for FY '01 included \$6.64 million in bonds sold by VEHBFA on behalf of the Vermont Council of Developmental and Mental Health Services Acquisition Program in its statistics for FY '00 and FY '01. That issuance has been excluded from the debt totals in this report. See Section I (D): Recent Developments Regarding Net Tax-Supported Debt.

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For FY'02, the Committee recommended, and the Legislature authorized, \$39 million in general obligation debt. In November and December of 2001, the State issued \$51 million in general obligation bonds. This represented the remaining authorized debt of \$12 million for FY'01 and the \$39 million authorized for FY'02.

For FY'03, the Committee recommended, and the Legislature authorized, \$39 million in general obligation debt. In December '02, the State issued \$30.8 million in general obligation bonds and will issue \$5 million in Citizens Bonds in January '03 for a total of \$35.8 million. The FY'03 Capital Bill authorized the purchase of the Vermont Mutual Insurance building with \$3.2 million in bond proceeds. Because purchase of the building was not likely to occur in FY'03, the issuance of general obligation bonds for its purchase was deferred leaving \$3.2 million of authorized, but unissued, debt for FY'03.

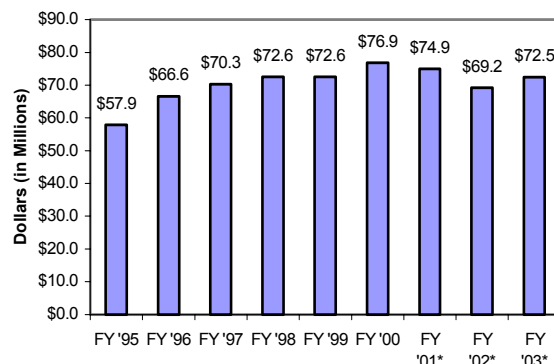
The State took advantage of low interest rates and also issued Refunding Bonds in the amount of \$31,555,000 in December 2002. These Bonds refinanced a portion of the State's 1993 Series B General Obligation Bonds. This refinancing resulted in a present value savings of 2.95%, or \$942,909.

Total debt service, i.e. the amount necessary to pay principal and interest on bonds, for FY'03 increased by 4.8% to \$72.5 million, compared to \$69.2 million in FY'02. This increase comes after a 6.66% decrease in FY'02 and a 1.5% decrease in FY'01. Future debt service payments will continue to fluctuate over the next decade and are not expected to show any steady decrease until FY'11. (See Chart 3.)

For FY'04, the Capital Debt Affordability Advisory Committee again recommended \$39 million in general obligation debt. The Com-

mittee agreed to consider building an inflation factor into the \$39 million authorizations in the future. Because of the decline in the economy and decrease in the State's revenue and resulting pressures on the FY'04 budget, the Committee declined to increase its recommended authorization for FY'04.

CHART 3
Net Tax-Supported Debt Service
FY '95 - FY '03



* Excludes \$6.64 million in bonds sold by VEHBFA on behalf of the Vermont Council of Developmental and Mental Health Services Acquisition Program.

B. THE STATE'S BOND RATINGS

Between September 1999 and September 2000, each of the three major credit rating agencies upgraded the State's general obligation bond rating. In September 1999, Moody's upgraded the State's rating from Aa2 to Aa1. In October 1999, Fitch upgraded the State from AA to AA+. In September 2000, Standard & Poor's upgraded the State's AA rating to AA+. This was the second upgrade by S&P in two years, as its previous upgrade from AA- to AA occurred in October 1998.

The rating agencies affirmed the State's ratings in connection with the bond issuances in December 2002. Several positive factors were taken into consideration by the rating agencies, including the following:

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- Conservative financial policies that have been consistently followed with conservative revenue estimates and moderate growth in spending limits;
- Healthy stabilization reserve levels that position the State to accommodate revenue shortfalls;
- Swift and prudent actions to balance the FY'02 and FY'03 budgets including the downward revision of revenue projections and reductions of appropriations as the economy weakened;
- An uncomplicated debt management system with a nearly exclusive use of general obligation debt;
- A favorable and manageable debt burden that is declining due to rapid amortization schedules and reductions in the State's debt issuance.

Whenever the State of Vermont enjoys a higher rating it enhances the marketing of its long-term debt and should result in lower interest rates that the State pays to borrow money. It is also likely to reduce borrowing costs for municipalities that issue debt through the Vermont Municipal Bond Bank, as well as enhancing the State's reputation in the municipal marketplace.

Vermont still enjoys the highest bond rating in New England and has avoided the downgrades experienced by some states in the past year due to the economic downturn.

C. DEBT STATISTICS

In assigning a rating to a State, the rating agencies consider several key indicators. In

1995, the State, through the Capital Debt Affordability Advisory Committee, established guidelines for the State as acceptable ratios for these key debt factors. The Committee monitors the State's progress in meeting these guidelines annually and in formulating its recommendation of the total amount of long-term general obligation debt that the State can afford and should authorize each year. Several ratios continue to show improvement.

1. *Debt Per Capita*: One of the key debt factors monitored by the Committee is the ratio of the State's net tax-supported debt per capita. The guideline followed by the State establishes an acceptable ratio of debt per capita at \$706 in 1995 dollars. Each year this figure is adjusted for inflation. After adjustment, the guideline for FY'02 was \$793 while the State's debt per capita ratio as of June 30, 2002 was \$748 compared to \$747 in 2001.² The State's ranking improved from 15th to 18th. The higher the ranking, the lower a state's debt per capita relative to all other states. Vermont's ranking is still relatively high with 32 states having less debt per capita than Vermont.

Currently for FY'03, the State's projected debt per capita of \$734 is below the inflation-adjusted target of \$818 for this year. Assuming a steady level of authorization of \$39 million in future years, and employing the population forecast developed by Economic Policy Resources, the State's net tax-supported debt per capita is forecast to decrease each year and will be below the State guideline through 2013.

2. *Debt as a Percentage of Personal Income*: The State applies a guideline that the total amount of projected State debt should not exceed five percent of aggregate State personal income. The State has steadily improved in this area and the State's ratio of debt to per-

² Debt per capita ratios for FY '01 and FY '02 do not include \$6.64 million in VEHFBA debt.

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sonal income for FY'02 dropped from 3.3% to 3.0%, the lowest level since 1990. The State's ranking in its debt as a percentage of personal income improved from the 10th highest among the states in 2000 to 14th in 2001 and remained at 14th in 2002.

3. *Debt Service as a Percentage of Revenue:*

The State remained in compliance in FY'02 with its established guideline with respect to a third key debt ratio – debt service as a percentage of revenues. The guideline used for this ratio states that projected annual State debt service on bonds should not be in excess of eight percent (8%) of projected revenues in the combined General and Transportation Funds during the next ten years. Debt service as a percentage of revenues ratio was at 6.7% as of June 30, 2002. This percentage is expected to increase in 2003 and then decrease through 2013.

D. RECENT DEVELOPMENTS REGARDING NET TAX-SUPPORTED DEBT

As is evident from the above discussion, the amount of the State's overall tax-supported debt as defined by the agencies is a significant factor in the award of a credit rating. The State's debt statement included, for the first time in 2001, \$6.64 million of revenue bonds issued by the Vermont Educational and Health Buildings Financing Agency on behalf of the Vermont Council of Developmental and Mental Health Services Acquisition Program (hereinafter the Program). Providers in the Program are non-profit corporations formed to operate human services programs in the State for individuals in need of mental health and rehabilitation services. Because the State provides approximately 80% financial support through appropriation to the providers in the Program and the providers are delivering basic State services, one of the three rating agencies concluded last year that the debt should be included in its calculation of net tax-supported

debt when analyzing the state's credit. That agency later concluded, after clarifying information about the source of the state funding and the relationship between the State and the mental health providers that the debt did not need to be included on the State's debt statement.

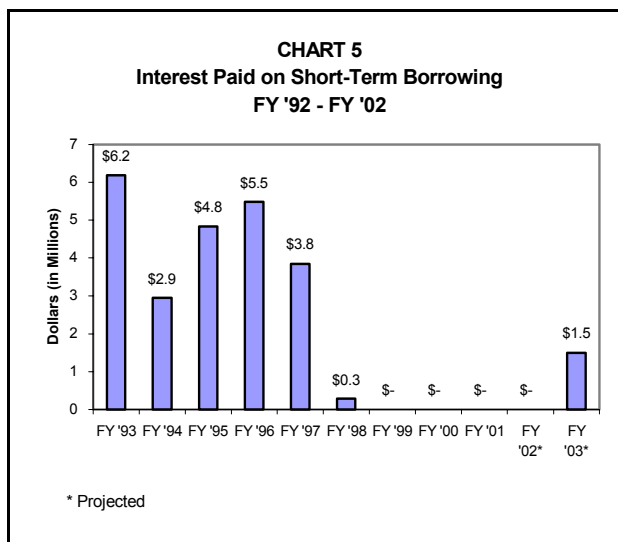
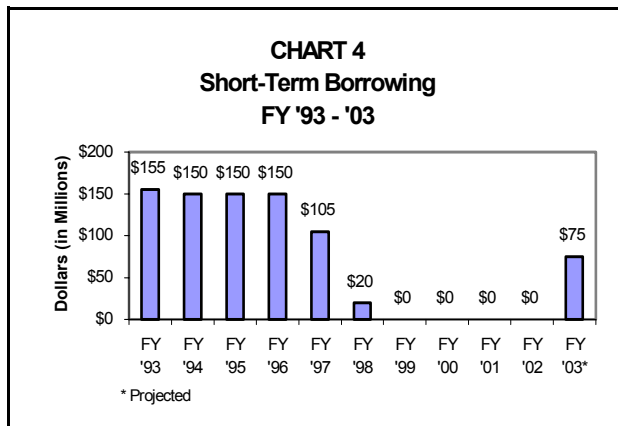
As a result of this initial conclusion regarding the mental health providers' debt, the Legislature enacted 32 V.S.A. §711 in 2001 that requires any entity that receives a majority of its operating expenses from either direct or indirect state appropriations to notify and obtain approval from the Governor and the State Treasurer prior to incurring any debt. The purpose of section 711 is to identify entities whose debt could affect the overall debt position of the State of Vermont prior to its issuance, to enhance the State's debt management practices with respect to the use and size of net tax-supported debt, and to protect the State's credit rating. In 2002, the Legislature further refined the language of section 711 to clarify that in calculating the state appropriation, non-discretionary federal funds (i.e. special revenue funds) as presented in the State's comprehensive annual financial report are not included. The amendment also limited the section's application to debt issuances in a cumulative principal amount greater than \$1 million.

E. SHORT-TERM DEBT

The State has made great strides in the area of short-term debt. The State's strong cash position did not require the issuance of short-term debt in fiscal years 1999-2002. In the early 1990's, Vermont was issuing between \$155 and \$192 million annually, not including \$65 million in deficit notes. (See Chart 4 on the following page.) In the past, the rating agencies expressed concern about why the State's cash flow position necessitated such high lev-

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els of short-term borrowing and have cited the reduction in short-term borrowing as a significant factor in their upgrades of the State's ratings. Besides the positive view held by the rating agencies, the State has saved significant money by avoiding interest charges on borrowed dollars as reflected in Chart 5.



The State's cash position in FY'03, however, did necessitate the borrowing of \$75 million in August 2002 as cash flows projected a deficit of that amount in December 2002. The State issued \$75 million in revenue anticipation notes that mature on June 16, 2003. The notes bear a coupon rate of 2.5% and interest on the notes is \$1.5 million.

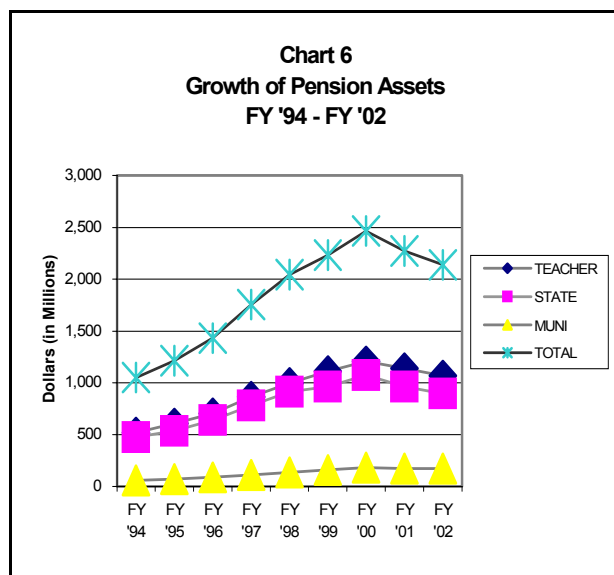
The amount and duration of short-term bor-

rowing is usually dependent upon two critical factors: a recurring revenue stream matching recurring expenditures (in other words, an ongoing balanced budget), and a healthy budget stabilization reserve, so that seasonal or economic dips in revenue as well as heavy expenditures that do not match up precisely with times of heavy revenue collection are offset by this reserve. Although Vermont did not achieve its goal to avoid short-term borrowing in FY'03, the General Assembly is expected to continue to maintain balanced budgets and return to fully funded reserves as quickly as possible.

II. INVESTING

A. LONG-TERM INVESTMENTS

The State Treasurer's Office administers the investment policies and strategies adopted by the Boards of the Vermont State Retirement System, the State Teachers' Retirement System of Vermont, and the Vermont Municipal Employees' Retirement System. The three systems had combined assets of more than \$2.1 billion on June 30, 2002 that represents an increase of 114% for the past nine years and an 8.8% average annualized growth rate. (See Chart 6.) A detailed statement of each



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plan's fiscal year 2002 assets including a comparison to fiscal year 2001 is attached as Appendix A.

In order to insulate the portfolios from short-term market fluctuations, the three pension systems employ diversified investment strategies, which enable each portfolio to maintain stability through market cycles of different asset classes. Each system's assets are invested in stocks, bonds and real estate with an additional small allocation to alternative investments, such as venture capital partnerships. These investment categories have imperfect correlations, so if one category is faltering, another may be doing exceedingly well. This strategy minimizes the effects of short-term volatility that occurs within each asset class and is totally different from market timing, in which an investor attempts to predict the ups and downs of various markets. In this strategy substantial losses can occur if the timing decision is incorrect.

Fiscal year 2002 was a difficult year for the financial markets. Pension system assets decreased by 6.1% for the State Teachers' Retirement System of Vermont, 7.4% for the Vermont State Retirement System, and 0.2% for the Vermont Municipal Employees' Retirement System. Variations in asset value among the three systems are dependent on many factors. Among them are cash flow requirements, differences in asset allocation and early retirement incentives. Table 1 (next column) displays the asset distribution of the three retirement funds:

For the ten years ended June 30, 2002, the median public retirement plan in the United States had an average annualized total return of 9.5%, compared with 9.5% for the Vermont State Retirement System, 10.1% for the Teachers' System and 10.6% for the Municipal Employees' System. Vermont's systems, therefore, have performed as well as, or better,

than most.

Table 1
Asset Allocation of Three Retirement Funds
Quarter Ending June 30, 2002

Investment Category	State	Teachers'	Municipal
Domestic Equity	41%	41%	38%
Domestic Fixed Income	21%	12%	33%
International Equity	17%	17%	19%
Global Fixed Income	10%	19%	0%
Real Estate	9%	10%	7%
Other	2%	1%	3%

B. SHORT-TERM INVESTMENTS

The State Treasurer's Office manages the investment of the State's cash in its short-term investment program. The short-term portfolio earned over \$4.8 million in interest income in fiscal year 2002 on average daily balances of \$189 million. Of this amount, \$3.1 million was transferred to the general fund. The yield on the portfolio was 2.3% for the year, which is 0.2% higher than the average three-month treasury bill auction rate of 2.1%. The Treasurer's Office solicits offerings daily from the institutional trading desks of dozens of national and local brokers in order to achieve the maximum rate of return and diversification in the portfolio.

C. THE VERMONT TRUST INVESTMENT ACCOUNT

The 2000 Legislature authorized the establishment of a trust investment account administered by the State Treasurer for purposes of investing restricted funds with non-expendable principal balances. As of June 30, 2002, the fund had a principal balance of approximately \$33.3 million, of which \$24.9

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million was allocated to the Tobacco Trust Fund, \$7.8 million to the Higher Education Endowment Trust Fund, and the remainder to various smaller trust funds. For FY'02, the fund had a total return of 7.07% versus the target return of 3.12%. For the same period, the S&P 500 Stock Index returned -17.98% and the Lehman Aggregate Bond Index returned 8.64%.

D. VERMONT HIGHER EDUCATION ENDOWMENT TRUST FUND

The 1999 Legislature established the Vermont Higher Education Endowment Trust Fund and appropriated \$6 million for the creation and management of the fund by the State Treasurer. An additional \$1 million was added to the fund in fiscal year 2001 and \$635,881 at the end of FY'02. On June 30, 2002, the fund had a market value of \$7,779,947. In August of 2002, the State Treasurer authorized the distribution of 5% of the average market value of the assets over the prior nine quarters equally among the University of Vermont, the Vermont State Colleges and the Vermont Student Assistance Corporation. Each received \$116,225 to be applied as non-loan financial aid to Vermont students attending Vermont post-secondary institutions.

In addition to the above disbursements from the fund, the Vermont Commission on Higher Education Funding authorized the Treasurer to make available the additional 2% distribution of \$128,524 to be divided equally between the University of Vermont and the Vermont State Colleges for application to their respective permanent endowments. In FY'03, the additional endowment allocation will be \$69,735 for each institution, provided that it is matched on a two-to-one basis by external donations for endowment purposes by the end of the fiscal year. A copy of the State Treasurer's Annual Report to the Commission is attached as Appendix B.

E. TOBACCO LITIGATION SETTLEMENT FUND AND THE TOBACCO TRUST FUND

In November 1998, Vermont was one of 46 states to enter into a settlement agreement with four major tobacco companies. The State's estimated share of settlement payments at the time was expected to total \$806 million over the first 25 years of payment and an additional \$156 million of strategic contribution payments to be paid between 2008 and 2017. To date the State has received payments that total nearly \$95.5 million.

Pursuant to the Agreement, the expected settlement amounts are adjusted for inflation and the effect of any decreases in the sale of tobacco products to the base year. To date, these have accounted for a 13% decrease. It remains difficult, therefore, to predict the amount of the future payments due from the tobacco settlement that will be received by the State. According to the Master Settlement agreement with tobacco companies, Vermont's expected and actual receipt of settlement funds are as follows (in millions):

	<u>Expected</u>	<u>Actual</u>
FY'99/00	\$36.23	\$33.21
FY'01	28.47	24.68
FY'02	34.18	31.00
FY'03	34.51	29.33*
FY'04	28.80	24.48*

* estimated

In fiscal year 2000, the Vermont Legislature established a Tobacco Litigation Settlement Fund to be administered by the State Treasurer. For fiscal year 2003, the Legislature appropriated \$17.25 million (the same as fiscal years 2001 and 2002) to healthcare services and \$6.721 million to programs in the Health

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and Education Departments for tobacco enforcement, prevention and education programs. Additionally, \$1.9 million was appropriated to substance abuse and youth protection programs in the Agency of Human Services. The remainder of the receipts is earmarked for the separately established Tobacco Investment Trust Fund, a trust established to eventually endow the education and prevention programs. These receipts were transferred by the Legislature to the general fund at the end of FY'01 and FY'02 to offset projected budget deficits. The Trust balance at the end of fiscal year 2002 was \$24.6 million.

F. VERMONT VETERANS' HOME

By legislative act, the Vermont Veterans' Home was required to transfer its endowment fund to the State Treasurer. In the fall of 2001, the Home transferred \$455,441.85 to the State. The legislation allows the State Treasurer to invest these funds, if appropriate, with the long-term investments in the Investment Trust Account. The funds were invested with the State's short-term investments until a spending policy for these funds was established by the Board of Trustees for the Vermont Veterans' Home. At their September 2002 meeting, a spending policy was adopted that allowed for transfer of the funds to the Vermont Trust Investment Account. The funds were deposited in the trust as of October 1, 2002. In December, the Vermont Veterans' Home received a bequest of \$410,000 that was deposited into the trust account as a separately named fund on January 1, 2003 pursuant to the terms of the bequest.

III. RETIREMENT

A. OVERVIEW

The State Treasurer's Office administers three statutory pension plans: the State Teachers' Retirement System of Vermont with 10,257

active and 3,991 retired members as of June 30, 2002; the Vermont State Retirement System with 7,725 active and 3,633 retired members; and the Vermont Municipal Employees' Retirement System, with 4,924 active and 903 retired members. Both the State Teachers' Retirement System of Vermont and the Vermont State Retirement System are funded by employee contributions as well as those made by the State. The Vermont Municipal Employees' Retirement System involves no State money.

The administration of the three programs has grown in both size and complexity over the years. With the aging workforce, the administrative requirements of the programs are expected to increase for the foreseeable future. The Vermont Municipal Retirement System would be more appropriately administered through the municipalities themselves. This is not a new initiative. The Senate passed S. 99 during the 1997-98 Legislative Session that created an inter-municipal retirement system to assume the administration of the Vermont Municipal Retirement System. The reallocation of the time and effort dedicated to this program would alleviate many of the increasing pressures we currently have in the administration of the State and Teachers' Retirement Systems. Although there are no immediate general fund savings associated with this transfer, future savings certainly can be expected through the deferral of new positions and costs, which will become necessary as our workforce continues to age and retire at an increasing rate.

B. FUNDING OF THE RETIREMENT SYSTEM

Pursuant to Governmental Accounting Standards Board Statement No. 25, the funding status of the State and the Teachers' Retirement Systems has improved (see Table 2), although the two largest systems remain actuarially underfunded. The General Assembly has

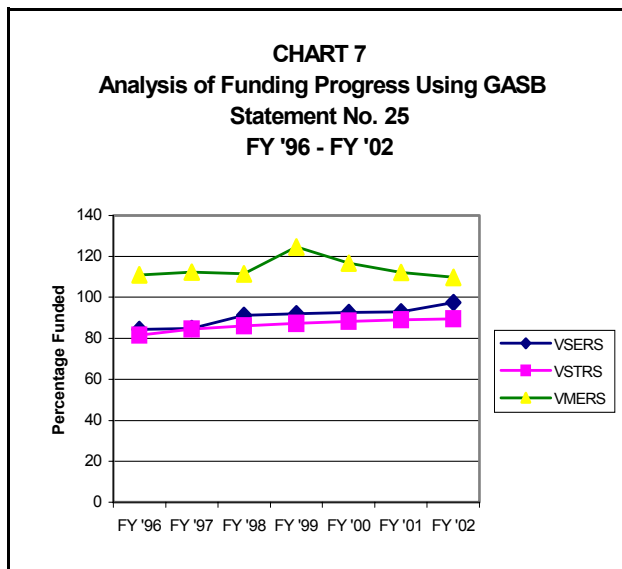
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appropriated less than the actuary's recommended contribution to the Teachers' System throughout the past decade. The higher than average investment returns of the past ten years have improved the funding levels of the systems, despite the disappointing returns over the last two years, largely due to the smoothing method utilized by the systems' actuary.

Table 2
Percent Funded Using GASB Opinion No. 25

	Teachers	State	Municipal
Actuarial Value of Assets	\$1,169,293,733	\$990,449,512	\$193,277,690
Actuarial Accrued Liability (AAL)	\$1,307,202,000	\$1,017,129,000	\$176,109,000
Unfunded AAL (UAAL)	\$137,908,000	\$26,679,000	(\$17,168,907)
Funded Ratio	89.5%	97.4%	109.7%

A comparison of the funded status in recent years is contained in Chart 7.



Based upon the actuarial recommendation, the Boards of Trustees for the systems have requested \$29,608,892 in FY'04 for the State's contribution to the Teachers' Retirement System and a \$10,248,197 contribution to the State Retirement System.

C. DEFERRED COMPENSATION PROGRAM

The Board of Trustees for the Vermont State Retirement System administers a deferred compensation program that has been available since 1973 as a savings option for State employees, municipal employees, employees of agencies such as VSAC, VEDA and VHFA, and members of the General Assembly. In calendar year 2002, a plan participant under age 50 could defer up to \$11,000 per year of his or her annual compensation and invest that money in one or more of the 15 mutual funds offered in the plan. A participant over age 50 could defer \$12,000. On June 30, 2002, the plan had 4,872 State participants and 246 local participants for a total of 5,101 participants.

As of June 30, 2002, total assets in the plan were valued at \$134 million. Participating employees made contributions in the amount of \$11.81 million to the plan during FY'02. Because the deferred compensation plan qualifies as a section 457 plan under the Internal Revenue Code, the portion of salary that is deferred is not taxed at the time of deferral. The Board of Trustees for the Vermont State Retirement System adopted a policy to waive fees for new enrollees in the plan after January 1, 2001 for the first full year of enrollment. This is one way to encourage participation in a plan that decreases taxable income during active employment and increases savings for retirement.

After a competitive bid process, the third party administrator of the plan was changed effective October 1, 2002 to BenefitsCorp, a Great-West company. Fees for participants in the plan were lowered by ten basis points as a result of the change in contractor.

D. DEFINED CONTRIBUTION RETIREMENT PROGRAMS

In 1998, the General Assembly offered active

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exempt State employees the option of remaining with their existing defined benefit plan or transferring their accrued benefits to a newly established defined contribution plan. Out of a pool of 806 eligible exempt employees, 349 (43%) elected to leave their State retirement defined benefit plan and transfer to the defined contribution plan whereby employees select from a menu of investment options. Exempt employees hired on or after January 1, 1999 are given the option of choosing between the two retirement plans. In 1999 the defined contribution plan was extended to terminated, vested State members who were exempt employees at the time of separation from service. Of the 51 eligible vested members, 45 elected to transfer to the DC plan. The defined contribution plan has continued to grow in terms of total participants. At June 30, 2002, the plan had 530 participants and a total market value of \$25,732,372.

Under the defined contribution plan, which is modeled after private sector 401(k) plans, employees contribute 2.85% of their annual salary to their individual accounts. The State makes a fixed contribution of 7% to each employee's account. Employees are responsible for making all investment decisions among options selected by the Treasurer. At retirement or termination, employees receive the amount of contributions in their accounts, plus investment earnings. The defined contribution plan provides portability for an increasingly mobile workforce. It also reduces the unfunded liability for the State because the State does not assume the liability of a future pension benefit.

The Vermont Municipal Employees' Retirement System was given statutory authority in 1999 to approve a defined contribution plan for its members. The Board implemented a defined contribution plan on July 1, 2000. The plan provides the employer municipality with the first option of deciding whether to of-

fer a defined contribution plan to its employees. Once a municipality elects to offer the plan to all eligible employees or to specific employment groups, an individual employee has the choice to remain with the defined benefit plan or transfer to the new defined contribution plan. New employees of municipalities offering both a defined contribution plan and a defined benefit plan will have a choice of either plan. During the first year, 62 employers offered the plan to approximately 800 employees. Two hundred (200), or 25%, elected to transfer to the DC plan effective July 1, 2000.

At June 30, 2002, 87 municipalities had offered the plan with 389 participants and a total market value of \$4,689,151.

E. ONE-TIME STIPEND FOR MILITARY SERVICE

Legislation was enacted effective July 1, 2001 that provided a one-time stipend of \$500.00 for each year, up to a maximum of three years, to retired members of the State and Teachers' Retirement Systems who served in the military during World War II, the Korean or Vietnam Conflicts. In order to qualify for the stipend, a retiree must have served, prior to becoming a member, a minimum of one year of full time service in the military during the periods December 7, 1941 through December 31, 1946, June 25, 1950 through January 31, 1955, or August 5, 1964 through May 7, 1975, for which the retiree had derived no military pension benefits other than for non-regular (guards or reserves) service. In addition, the retirees must have retired before the military service was available as a grant to active members.

Applications were filed between July 1, 2001, and June 30, 2002. Stipends totaling \$547,633 were paid to 511 State employee retirees and \$182,162 to 210 teacher retirees.

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IV. ABANDONED PROPERTY

The primary function of the Abandoned Property Division is to locate and return money and other property to its rightful owners or their heirs. This property is most often in the form of money, but it can also be stocks, bonds, mutual funds and contents of safe deposit boxes. This property comes from many sources including banks, credit unions, corporations, utilities, insurance agencies, retailers and governmental agencies throughout the United States. The State of Vermont acts as custodian to safeguard it until it can be claimed by its rightful owners or their heirs.

Currently, more than \$17.4 million of unclaimed property is held by the State Treasurer. In FY'02, holders of unclaimed property turned over \$3.5 million to the Abandoned Property Division. Over the last eight years, Abandoned Property receipts have increased from less than \$1 million to an average of over \$3.5 million for the past four years. Several years ago the Treasurer's office initiated an amnesty program that allowed holders to report for the first time without fear of penalty. This program was highly successful and encouraged holders to report every year. The Abandoned Property Division also stepped up its outreach program to holders. Holder information is now posted on the Treasurer's website and holders are able to print out reporting forms.

The Abandoned Property Division paid a total of \$1.8 million in claims in FY'02. The average claim paid was \$623.13. The largest claim paid was \$404,400.

Vermont makes a diligent effort to locate missing owners and reunite them with their lost assets. The help of town clerks and state legislators has been enlisted and the names of owners have been posted on the internet. In fiscal year 2000, the Treasurer's Office was

one of the first states to be linked via the internet to a central national website through which the public can more easily access the office's website. Users of the State's website now have the ability to download reporting and claim forms. Thousands of "owner" letters are sent each year, the office staffs a booth at the Champlain Valley Fair, and owners' names are published annually in newspapers around the State as required by statute. Reciprocity with other states in order to return abandoned property to the state in which the owner most recently lived has also proved effective in returning property to its rightful owner as quickly as possible. It also allows holders to report only once instead of reporting to multiple states.

V. AUDIT COMPLIANCE

In fiscal year 1999, an Audit Compliance Division was created within the State Treasurer's Office. This Division conducts independent reviews of the diverse operations and controls within the office to determine whether acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically in reaching the organization's objectives.

This year, with the implementation of the new accounting system, VISION, the Division has been conducting a post-audit of the office's expenditures on a daily basis and assisting in solving problems as they are discovered in the new system.

The Division continues to assist the Accounting Division in reviewing the more than 250 departmental cash accounts. A format for controlling these accounts has been implemented and additional financial disclosure has been prepared for the State's Comprehensive Annual Financial Report (CAFR).

In addition, the Division has been actively in-

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volved in reviewing the work performed by the State's contractor who provides the accounting for the State's pension investment funds.

VI. FINANCIAL MANAGEMENT

A. ELECTRONIC BANKING/PAYMENTS/ TRANSFERS

The State Treasurer's Office encourages electronic transmissions of such items as vendor payments, payroll, welfare and other benefits. Most payments to municipalities are now handled electronically. In FY'02, the Treasurer's Office processed approximately 1.5 million payments; 27% were electronic transfers. Our goal continues to be to increase the proportion of financial transactions that occur electronically.

The Treasurer's Office continues to encourage State employees and retirees to authorize direct deposit of their paychecks and retirement checks. Direct deposit is a more efficient, less costly and safer method by which to transfer funds. In December of 2002, 78% of retired municipal employees, 87% of retired State employees, and 90% of retired teachers received their monthly benefit payments via direct deposit. This is an increase from the December 2001 percentages of 78%, 86%, and 89% respectively, up from approximately 50% five years ago. Currently 6,824 State employees, or 78%, have their biweekly pay deposited directly to their bank accounts, up 3% from a year ago.

B. PROJECT VISION

The State implemented a new financial management system, Project VISION, on July 1, 2001. The system posed many challenges for the Treasurer's Office and has delayed completion of some treasury functions, such as reconciliation of bank accounts. The Office is

working closely with the Administration to insure the continued development of report capabilities and processes necessary for the Treasurer's Office to do its work.

An accounting firm was retained to assist with the development of new procedures for the reconciliation of accounts in VISION and to assist with reconciliation's because the Treasurer's Office was unable to start the process on key accounts until a general ledger was available in February 2002. The firm completed the reconciliation of several accounts for FY'02, developed written reconciliation procedures, and identified areas for correction or improvements to the VISION system. Among the firm's recommendations were for the Department of Finance & Management to provide more accounting and VISION training to VISION end-users, to institute and monitor better internal controls at the department levels where the majority of accounting entries are now made; and to develop prompt and consistent timeframes for the closing of the State's books on a monthly basis. With these improvements, the amount and scope of the mistakes needing adjustment during the reconciliation process by the Treasurer's Office should decrease and reconciliation's could be completed more quickly. The firm also noted the need for more resources in both the Treasurer's Office and the Department of Finance to create the needed oversight of a decentralized accounting system.

In FY'03, an additional permanent position was added. This position is essential to the added responsibilities of the Treasurer's Office as a result of Project VISION.

C. BANKING SERVICES

On January 1, 2002, Franklin Lamoyille Bank, Howard Bank and First Vermont Bank merged to become a division of Banknorth, N. A., operating under the single name of

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Banknorth Vermont. Banknorth Vermont continues to serve as the State's master banking contractor. Bank personnel have worked thoughtfully and diligently with Treasury staff to provide secure and efficient services to the State. The Treasurer's Office is working to connect through the World Wide Web to state-of-the-art financial services offered by the Banknorth Group, Inc. It will allow Treasury personnel to access up-to-the minute account information thereby improving cash flow forecasting and funds management. In January 2003, the Treasurer's Office and Banknorth will implement a positive pay service that will not only provide an additional tool to detect potential fraud and forgeries on State checking accounts but will detect, on a daily basis, encoding and posting errors by the Bank in the State's accounts, thereby reducing the number of reconciling items each month.

D. INTERACTION WITH THE AUDITOR OF ACCOUNTS' OFFICE AND COMPLIANCE WITH AUDIT FINDINGS

Interaction with the Auditor of Accounts' office is essential to improvements in the State's financial reporting systems. The Auditor's office has offered financial reporting recommendations over the years that have proven helpful. In addition, every audit finding is taken seriously and, since the Treasurer's Office handles more than \$4 billion of retirement and State funds annually, its Audit Compliance Division is used to ensure proper financial controls. The number of audit findings relating to the Treasurer's Office has declined significantly in recent years.

E. ACT 60 RECEIPTS

The Treasurer's Office monitors the receipt of payments mandated by Act 60 after the Departments of Education and Taxes have notified towns and school districts of their respective liabilities. In FY'02, all towns and school

districts made their Act 60 payments.

To date, all districts except two made their Act 60 payment that was due on December 1, 2002. The Treasurer's Office is in the process of conferring with the delinquent entities to encourage compliance and collect interest on the late payments. As in the past, unresolved delinquencies will be referred to the Attorney General for collection.

VII. LEGISLATIVE REPORTING REQUIREMENTS

A. BRANDON TRAINING SCHOOL

Section 23 of Act 62 (Capital Bill) of the Public Acts of 1995 specifies that the State Treasurer notify the chairs of the Senate and House Institutions committees upon receipt of monies from the sale of the Brandon Training School property as well as certain federal receipts associated with the Vermont Veterans Home. The State has received amounts due from the federal government for reimbursement of expenses associated with the Vermont Veterans' Home. No property belonging to the Brandon Training School was sold in FY'02.

B. MCBRIDE PRINCIPLES

Act 50 of the Public Acts of 1989 specifies that the State Treasurer and the Retirement Boards compile a list of corporations that conduct business in Northern Ireland in which the State Treasurer and Retirement Boards have invested funds. Notification from external investment managers is due in the Treasurer's Office on January 1 of each year. This list is available for examination in the State Treasurer's Office.

C. BURMA (MYANMAR)

Act 13 of the Public Acts of 1999 specifies

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that the Treasurer shall implement the purposes of the Act by voting in favor of shareholder resolutions concerning an individual company's doing business with the government of Burma. In addition, the Treasurer shall separately notify the company that Vermont wishes to convey its grave concerns regarding the company's economic ties to the government of Burma. The Treasurer has complied and continues to comply with his obligation under this Act.

D. FIREFIGHTERS' SURVIVOR BENEFITS

Act 119 of 2002 established a Firefighters' Survivors Benefit Review Board, effective July 1, 2002, to administer the grant of a one-time monetary benefit to the survivor or survivors of a firefighter who dies in the line of duty or of an occupation-related illness. Administrative support for the Board was assigned to the State Treasurer's Office. The Board is expected to finalize an application and determination process as well as a public awareness campaign of the fund in January of 2003.